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Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

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Four Recommendations

Now that the nation's two major political parties have nominated their candidates for president, serious campaigning is about to get under way. While there are many issues that need to be discussed, the fact that the U.S. economy remains mired in recession at the moment, and is faced with serious challenges longer run, has prompted many observers to offer advice to both major candidates. Depending on one's perspective, this advice can either be conflicting, or, at the very least, politically unpalatable. However, it is clear that something needs to be done in order to get our economy back on track.

As readers of this Report are no doubt well aware, the ongoing recession is only part of our economic problems. The rate of inflation, while somewhat less than at its high point at the first quarter of this year, stubbornly refuses to go below the double-digit range. Energy supplies are plentiful at the moment, but our dependence on foreign oil remains a potential trouble spot that will flare up when the demand for energy picks up once again. Our industrial base has been seriously eroded because of a variety of developments, causing a loss of some export markets and an increase in imports.

I don't claim to have all the answers, but it seems to me that if policymakers were to adopt just four recommendations, the U.S. economy could return to the track of faster growth, less inflation and minimal dependence on foreign energy. I present them below, listed in the order I think they should be implemented, under current economic conditions.

Balance The Budget

In this summer of recession, many ideas have surfaced to cope with our twin problems of recession and inflation. Some of them are interesting, but inappropriate, considering the present state of the Federal government's budget. Specifically, I refer to those proposals that would involve cutting taxes. Given the projected increase in the tax burden for 1981 that I referred to in the July Report, it is very tempting to go along with those who say that taxes should be cut in order to get us out of recession. However, to reduce taxes without a corresponding cut in Federal spending would be to widen the deficit in the Federal government's budget at a time when it is already too big. This deficit indicates that, increases in the tax burden notwithstanding, the Federal government will still be imparting stimulus to the economy. Even more important is the fact that the deficit must be financed.

Any kind of tax cut — whether consumer-oriented, or business-oriented — will place additional strains on the financial markets when the budget is in deep deficit. No matter how fast these tax cuts may generate increased revenues, they can never do it fast enough to prevent the government from borrowing more money in the near term to make up for the sudden shortfall in revenues compared with expenditures. If the budget was in surplus and the economy was in recession, there would be no question in my mind that cutting taxes would be appropriate. This is because the few billion dollars increase in Federal financing requirements would not put pressures on the financial markets. But the Federal government this fiscal year has already had to raise $50 billion to cover its anticipated deficit of $60.9 billion — not to mention an additional $22 billion to finance the federally-sponsored off-budget agencies. And this does not include the $135 billion that must be raised just to "roll over" previously issued securities.

Even without a tax cut, the Federal government's financing needs are creating strains in the financial markets. The Federal Reserve has been attempting to keep the growth of money and credit to a rate which would slow inflation. This means that the Federal government's current financing needs may have already caused interest rates to stop falling and begin to rise. If money tightens further, liquidity in the private sector will diminish, hitting hard such sectors as homebuilding which are heavily dependent on the availability and moderate cost of credit.

Clearly, a tax cut unaccompanied by an equivalent cut in government spending, would only exacerbate the

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situation. Of course, the Federal Reserve could respond (as it has done many times in the past) to the greater financing requirements of the public sector by simply creating more money and credit. If the Fed were to do this, it seems to me, then all it would be doing is laying the basis for a new round of inflation sometime in 1981 or in 1982. This, too, would vitiate the effects of economic policy.

That is why my first recommendation is that we balance the budget. I don't say that the budget should be balanced this year or even next. But I do believe that we should not disturb the tax structure so as to push further into the future the prospects for a balanced budget. Of course, it would help if we could curb Federal spending. However, given international tensions as well as domestic political pressures, I don't deem the likelihood of curbing Federal spending very great. So to keep on the track toward a balanced budget, we must preserve tax revenues. And to do this, we must eschew a tax cut. Since none of the tax cut proposals now in the hopper are likely to take effect before the beginning of 1981 at the earliest and since most economic forecasts project that the economy will be in recovery by then, I don't see much danger to the recovery from not cutting taxes. Indeed, even its staunchest advocates want a tax cut in 1981 not as an anti-recession weapon, but rather as pro-recovery insurance. In my view, the only thing we will be insuring if we cut taxes at this point is an early revival of inflation.

Decontrol Energy

Next to recession, the question of our dependence on foreign oil is most vexing. I am aware that we have made some progress toward decontrol. Natural gas shipped interstate is no longer subject to the tight layer of price controls that it once was. And some types of oil produced in the United States are free to be sold at world market prices. However, a large proportion of oil produced domestically remains under some form of price control. What is more, the Federal government, through the Department of Energy, has taken it upon itself to tell the oil companies where to ship this oil — in other words what region should get how much oil and gasoline.

When there is an excess amount of petroleum such as is the case today, this interference with the marketplace does not cause many problems. However, it continues to distort the price and production mechanisms sub rosa, laying the groundwork for future distortions when demand and supply come into better balance. And, when demand outstrips supply as was the case last year, Federal government interference only makes things worse.

I believe that the government should step out of the energy picture immediately. Whatever prices remain under control should be immediately freed to rise to world prices, and the government should cease and desist the allocation of petroleum products as well. Now is the best time to do this, while energy supplies are in excess compared with demand. Chances are retail prices for petroleum products will rise hardly any, if at all under present circumstances. Yet, by returning to the principles of the free market, the Federal government will be helping to make sure that we don't undergo a repetition of the long gas lines and sudden price hikes characteristic of the springs of 1974 and 1979.

Even now, there are a record number of rigs in operation drilling for oil. And the American Petroleum Institute reports that oil production in the 48 contiguous states rose in July compared with last year, the first monthly gain in over three years. Who knows how much more oil and gas exists that has either yet to be found, or is known to exist but is still too expensive to bring up, given current prices? I say no one knows, least of all the Federal government. That is why I believe that the pricing mechanism should be the marketplace and not the dictates of Washington.

Needless to say, there are other energy sources that we can turn to besides petroleum. Some, like coal and nuclear power, are already in use, but are having their problems with various groups of people. Others like coal gasification and liquifaction, shale oil, solar energy and geothermal power are being researched, but are still too expensive to be commercially viable.

I don't want to overlook the demand side. Already, the U.S. has made a major adjustment to higher energy costs. Gasoline use so far in 1980 is down anywhere from eight to ten per cent compared with the same time last year — and in some months has been as low as it was in 1973. This is no small feat considering that there are 20 million more vehicles on the road today than there were then. Some say this adjustment has been made by people driving smaller cars, which get better gas mileage. Others say it reflects a reduced rate of driving. Whatever the case, it seems to me that the bottom line is the same: Our use of gasoline is declining and will continue to decline as our mix of automobiles becomes even more skewed toward smaller, fuel-efficient models.

There are two other benefits that would flow from decontrol. The first is that our tendency toward oil-induced inflation would be minimized for reasons implicit in my discussion above. The second, and no less important, is on the international side, in the area of financial flows. It is no secret that payments balances of many countries in the world have been distorted significantly by the need to pay for high-priced oil. Indeed, the U.S. would be running a massive surplus on its international trade were it not for oil. Not only is oil covering up what is clearly a strong competitive position for many U.S. industries thus unnecessarily

cheapening the dollar, it is also responsible for the concentration of greater and greater financial resources in the hands of fewer and fewer countries, placing the burden on the international banking system to recycle these funds.

Restructure Taxes

We must also reorient our tax policy away from consumption and toward investment. Since my first recommendation above was that taxes not be cut in order to preserve the flow of revenues thus enhancing prospects for balancing the budget, what I mean here obviously is that business and investor taxes should be reduced while taxes on consumption should be allowed to rise. I recognize that this would be considered political heresy in an "off" year, much less in an Election Year such as we have in 1980. But as I have said many times in the past, what might make bad politics short run could make good economics, longer run. And it is the longer run to which we must address ourselves — the sooner the better.

I don't think there is much dispute that our tax structure as it exists today tends to dissuade businessmen from making investments in new machinery and equipment. The inability of businessmen to take into account the effects of inflation as they depreciate their physical plant, machinery and vehicles has caused them to pay more in taxes to the government than they should have, and left over less for new investments as a result. The rise of the capital gains tax has discouraged venture capital, seriously cutting into research and development outlays — especially among smaller companies where much of the innovations tend to occur. The so-called "progressive" tax structure takes away more income from those with the highest propensities to save and gives it to those with the greatest propensities to consume. While socially a seemingly desirable program, this tax structure has had the effect of reducing the pool of capital which business could tap in order to finance new investments.

I think that next year, after the elections are over, the government ought to seriously consider changing the tax structure to remove the bias against savings and investment. Some of the well-discussed proposals such as the "10-5-3" accelerated-depreciation package, which would let firms write off investments in buildings in ten years, machinery in five years and vehicles in three years, should be passed without delay. In addition, the investment tax credit should be increased, the capital-gains tax should be reduced and the progressivity of the tax structure moderated. I would also like to see more interest from savings being made exempt from taxation. To pay for this, we are going to have to tax consumption. There are several methods under consideration, which are likely to surface in the tax debates of 1981. I haven't made up my mind which one is best, but it seems to me that the widely-discussed value-added tax (VAT) is as good as any. Like any sales tax, the VAT is a tax on consumption: You don't pay taxes on what you don't spend. And of course, what you don't spend, you save.

Reduce Regulations

Besides tax and energy policies, the government has impacted the economy through its role as a regulator. Since the mid-1960s, there has been a sharp rise in intervention by governments on all levels, resulting in what Adam Smith might have called, "the visible hand." Laws, administrative rules and guidelines are in constant flux, and are becoming increasingly complex and costly. It has been estimated that Federal rules alone add as much as one percentage point annually to the rate of inflation, while the cost of Federal regulation well exceeds $100 billion annually. What is more, these regulations have begun to interfere with the orderly functioning of our economic machine, making it less efficient, and ironically, moving us away from our basic goals of full employment and stable prices.

To be sure, we have always had to deal with government regulation. Each session of governments on all levels has tended to pass many new laws and only rarely struck old ones from the books. But in recent years, government intervention has been transformed from a relatively uncomplicated type of economic regulation, applied to a limited number of areas, to a staggeringly comprehensive and complex set of social engineering programs in an effort to affect directly the behavior of a whole society. Issues formerly settled in the marketplace have now become the province of the Congress, delegated via legislation for administration by the Executive departments and independent agencies, and often decided by the courts, whose judges are scarcely prepared for such additional economic duties. These decisions, rules and regulations are usually made without regard to market forces, individual incentives or the profit motive.

What is worse, many of these regulations conflict with one another. On the one hand, as *Business Week* magazine recently noted, the Environmental Protection Agency is pushing hard for stringent air pollution controls. On the other, the Energy Department is encouraging companies to switch from imported oil to dirtier coal. The National Highway Safety Administration has mandated weight-adding safety equipment for cars while the Transportation Department is insisting on lighter vehicles to conserve gasoline. These are just two of the many examples that can be cited as the fist of fiat prevails again and again over the invisible hand.

Old agencies and obsolete programs never die. They just keep spending and regulating. Today, at least 1200 of these alphabet-soup agencies have significant

regulatory power — an increase of close to one third in ten years. The Federal register, that compendium of agencies, rules and regulations, has put on considerable poundage, more than doubling in size since 1970. There is another aspect to this increase in government interference with the private economy — its unpredictable nature. Unlike economic, technological or other uncertainties indigenous to the private, free enterprise system, political uncertainties tend to be sudden, swift and unprecedented. It is entirely possible for a multi-million dollar factory to comply with all rules and regulations one day, and be declared in violation the next. Businessmen and investors can cope with the uncertainties of the marketplace; they always have. However, they cannot deal with the ever-changing "rules of the game" that arise from more and more government regulation.

In the final analysis, this subject may be the toughest of all to tackle. What I am talking about is not only declaring a moratorium on new rules and regulations, but actually cutting back some of the existing ones in order to unfetter the private free enterprise system. In effect, I am asking politicians to stop passing new laws and, instead, to legislate many bureaucrats out of a job for the greater good of the American people. Your guess is as good as mine as to when, if ever, this will come about, but at least the issue has been joined, and the burden of proof is now on the regulators to justify their continued existence. H

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